

KY's Processor Manual



STATE PROCESSING MANUAL FOR PROCESSORS

WHAT IS PROCESSING?

Each year schools throughout the nation receive millions of dollars' worth of donated food for their meal service operations from the U.S. Department of Agriculture (USDA). USDA buys the food under price-support and surplus-removal legislation and offers it to recipient agencies through the Food Distribution Program of the Food and Nutrition Service. While some food items provided by USDA are purchased in ready-to-use forms, such as canned fruits or vegetables, other foods are provided in forms or quantities that may not be easily used, such as frozen whole turkeys. In order to make efficient use of these foods; many recipient agencies have turned to the food processing industry to convert the USDA donated foods into more convenient and usable forms.

Through processing, recipient agencies can economize on food costs, benefit from reductions in food preparation time and outlays for equipment, and make the most efficient use of donated food. Processing helps recipient agencies provide more varied and higher quality meals, reduces waste in the food preparation process, and stabilizes costs through portion control. Processing enables recipient agencies to realize significant cost savings. These cost savings can be in the form of a discount in the normal commercial price or by way of a refund from the processor.

Processing has become an integral part of day-to-day food service operations and its use will continue to increase as new menu items are developed by industry and introduced to the American palate. The processing of donated food must be done in accordance with the State Processing Program regulations (7 CFR Part 250.30).

HISTORY OF THE STATE PROCESSING PROGRAM

USDA's domestic food assistance programs administered by the Food and Nutrition Service (FNS) are this nation's primary defense against hunger and malnutrition. Through the Food Distribution Programs, millions of Americans receive donated food assistance on a daily basis to help meet some of the nutritional needs of children and needy adults. The programs also help support markets for food that American farmers produce.

To aid American farmers, USDA buys food under price-support and surplus-removal legislation and makes this food available to State distributing agencies. In addition, for some programs, funds are appropriated to purchase foods; the type and variety of which are controlled by market conditions. USDA pays for the initial processing and packaging of the food and for transporting it to designated points within each State. Distributing agencies are then responsible for storing the food, transporting it throughout the State, and distributing it at the local level to eligible recipient organizations participating in the various food programs.

Although the food donation programs date back to the 1930's, the authority for processing donated foods has only existed since the first processing regulations were issued in October 1958. It was not until the early 1970's that FNS began taking an active role in encouraging donated food processing. The impetus for this encouragement came from changes in Child Nutrition legislation, guaranteeing a designated level of donated food assistance based on meals served within the State. As the supply of donated foods became more constant; States and schools saw the opportunity to convert donated products into more convenient or table-ready items. This change helped expand donated food use from a limited number of commodities to a broader array of commodities.

However, with the dramatic expansion in donated food processing, FNS and USDA's Office of the Inspector General (OIG) became aware that oversight responsibilities had not kept pace with program growth. Both agencies soon discovered that more controls were needed to protect Federal, State, and local interests. In order to determine the severity of the problem, OIG conducted two national audits in 1978 and 1985. These audits, which verified that the regulations governing the State Processing Program needed to be strengthened in program accountability, oversight responsibilities, and contractual provisions, resulted in two major revisions in the processing regulations in 1981 and 1986. The major areas of concern that were disclosed by these audits were:

- More State and Federal monitoring of processor operations was needed in the State Processing Program;
- Processors were maintaining excessive donated food inventory levels;

- Processors were substituting inferior quality commercial foods for donated food; and
- There were insufficient Federal regulations and guidelines in place that contributed to poor program accountability.

Since that time, the State Processing Program has dramatically changed. With the increase in the variety of donated foods made available by USDA came the need to maximize donated food usage to produce nutritionally sound, well-accepted meal items, while keeping labor costs to a minimum. Distributing agencies and processing companies soon learned that working together was beneficial for everyone concerned. Below is a synopsis of the changes to the State Processing Program regulations that have taken place since 1958.

This first regulatory reference to the processing of donated foods required a written agreement between the contracting parties. At that time domestic food donation programs were administered by AMS.

This amendment revised contractual, performance, and review requirements as follows:

- Distributing agencies that provided donated foods to the Child Nutrition Programs, but which did not administer these programs, were required to consult with the State educational agency as to whether the processed products would meet the nutritional requirements for reimbursement under the Child Nutrition regulations.
- In the listing of ingredients on the end product data schedule, processors only needed to identify the total quantity of seasonings and flavorings used in the end product without requiring the identification of specific ingredients. This provision was designed to ensure that processors' "trade secrets" would be protected.
- In order to avoid disruption in production, those donated foods that could be substituted with identical commercial product without prior approval from the distributing agency were listed in the regulations.
- The mandatory labeling requirements for substitutable commodities were removed from the regulations.
- Since FNS is not a party to the processing agreement, FNS disclaimed any liability with regard to the provisions of processing agreements or performance thereto. This revision substantially increased the accountability requirements for States and processors.

- Several new definitions were added to the regulations including contract value, distributor, food service management company, processor, and refund system.
- The definition of contract value provided the processor with two methods for determining the value of the donated foods:
- USDA's cost of acquiring and delivering donated food based on USDA's most recent data or
- The processor's most recent data documenting the cost of purchased foods meeting or exceeding the food specifications delivered to the processing plant. However, when the contract value of donated foods was approved at a lower value than USDA's cost, the processor had to maintain records to substantiate the lower delivered cost and that the food purchased met or exceeded the donated food specifications.
- Distributing agencies had to submit an annual processing State plan of operations and develop a processing manual for use by recipient agencies and processors.
- The specific requirements that must be contained in processing contracts were identified.
- The use of a subcontract was required when a portion of processing was delegated to another company.
- While FNS recommended the use of a bond whenever possible to protect the value of donated foods received by processors, the distributing agency could require *any* alternative methods of insurance that covered the value of the donated foods in inventory at any particular time.
- Distributing agencies became responsible for providing processors with a list of eligible recipient agencies.
- Processors had to supply a wholesale price schedule for end products.
- A refund system for sales through a distributor had to be used unless another system was approved by the FNS Regional Office.
- Distributing agencies could approve requests for additional substitution of donated foods by processors upon receipt of a written request.
- The use of acceptance services graders for all production runs was required when the value of meat or poultry exceeded \$10,000.

- Refund applications had to be submitted no later than 90 days after the close of the school year. The processor was required to make payment within 30 days of receipt of the refund application.
- Processors were required to must submit monthly performance reports and distributing agencies were required to submit quarterly inventory reports.
- The maximum allowable inventory level held by a processor was raised from 4 to 6 months. Distributing agencies could approve a higher inventory level if deemed appropriate.

This regulation required processors to provide for a 100 percent yield for all substitutable commodities.

This major revision of the regulations was brought about by a second OIG national audit on processing. It further increased the requirements on accountability.

- The term “multi-State processor” was defined for the purpose of determining which processors would be subject to the certified public accountant (CPA) audit requirement. Multi-State processors were required to have independent CPA audits performed of their operations.
- The requirement for distributing agencies to submit an annual State processing plan of operations was eliminated.
- Competitive bid procedures and selection criteria had to be used when the numbers of contracts were limited by the contracting agency.
- Agreement duration was limited to one year.
- Processors were required to provide bonds, letters of credit, or escrow accounts in order to protect the value of donated foods against losses.
- Processors were required to maintain a quality control system.
- The use of the “hybrid” system for sales through a distributor was authorized. A sales verification requirement had to be part of this value pass-through system. Additionally, distributing agencies could no longer approve alternate value pass-through systems.
- Refund applications had to be submitted within 60 days of the date of purchase for both recipient agencies and distributors operating under the “hybrid” system. Processors were required to pay refunds within 10 days of receipt of the refund application. Refund applications could be mailed directly to the processor rather than through the distributing agency.

- Advanced approval for substitution was required, except to meet the 100 percent yield requirement and in instances where foods were stored together in joint bins or tanks.
- The use of acceptance services graders was required for all meat and poultry processing except in very limited situations.
- Each processor was required to report the pounds of donated foods in finished end products in a distributor's possession, along with the names of the contracting agencies under agreement with the processor.
- Processors were required to submit an annual reconciliation report.
- For excess inventories (over 6 months), the processor had to either seek approval for higher inventory levels or buy down inventory.
- Multi-State processors were required to submit independent CPA audit reports.
- The definition of contract value was restricted to USDA's costs of acquiring and delivering donated food based on USDA's most recent data.

The State Processing Program regulations were revised to allow the substitution of commercial concentrated skim milk for donated nonfat dry milk in processing agreements.

This regulation made the following changes:

- The definition of refund payment was amended to permit processors to credit distributors' accounts for sales made under the "hybrid" value pass-through system. Previously, processors were limited to paying refunds to distributors.
- The concept of allowing alternate value pass-through systems to be used was reintroduced into the regulation; however, only FNS could approve alternate value pass-through systems.

This regulation made the following changes:

- Sales verification procedures under the "hybrid" and alternate systems were changed to:
 - require sales verification semi-annually rather than quarterly;
 - require a sample size that provided a 95 percent confidence level;
 - require a 10 percent reverification subsample by the distributing agency when sales verification was delegated to the processor; and
 - require that a corrective action plan be undertaken for invalid sales.

- The school year (July 1-June 30) was established as the basis of all processing agreements. Agreements could begin any time during this timeframe, but had to end on June 30.
- Processors were required to provide distributing agencies with basic information concerning end products, but could be assured that “trade secrets” would not be disclosed. Processors had to continue to identify all ingredients contained in an end product, but were not required to specify the amount of each non-donated food ingredient contained in the end product. The total weight of the batch, however, had to be specified so that the percentage of donated food in the formula could be determined.
- For sales through distributors under “hybrid” or alternate systems, distributors were allowed to retain invoices rather than forwarding them to the processor.
- All invoices had to list the amount of the discount or refund due for donated foods contained in the end products sold.
- At the time of contract termination, the Commodity Credit Corporation’s unrestricted sales price was added as an option for determining the commodity value.
- The date that refund applications had to be submitted was changed from 60 days from purchase to 30 days following the month of purchase.
- The requirement that processors report pounds of commodities in end products held by distributors was deleted.
- The language regarding processor payment for excessive inventories at time of reconciliation was clarified.
- The multi-State processor audit cycle frequency had to include the value of foods processed under the National Commodity Processing Program, in addition to the value under State processing agreements.

Technical errors in citations contained in previously issued regulations were corrected.

For School Year 1988-89 only, processors were allowed to delay refund payments for end products made from donated cheese. This regulation came about as the result of USDA’s inability to make timely deliveries.

State performance standards were issued which required distributing agencies to administer an acceptable processing program. Distributing agencies were required to inform recipient agencies on an annual basis of the processing options. Distributing agencies or their recipient agencies were required to test

end products and distributing agencies were required to monitor the acceptability of processed end products.

PROCESSING AGREEMENT APPROVAL

A processing agreement is a legally binding contract between a processor and a distributing agency or recipient agency. This agreement contains the provisions that permit processors to receive and utilize USDA donated food as an ingredient in the production of a finished end product. In turn, a processor agrees to pass the value of the donated food through to the recipient agency in the form of a lower cost for the product. As with any contractual arrangement, the processing agreement is designed to protect the interests of all parties involved -- processor, the distributing agency, and the recipient agency.

Agreement Duration: The agreement begins on July 1 of each year and ends on the following June 30. An agreement may be entered at any time during the year. Distributing agencies have the option of extending processing contracts up to two additional 1-year periods, providing that any changes to the original agreement are updated and the extension is signed by both parties. The distributing agency must ensure that all required reports have been submitted in compliance with the original contract and should be satisfied with the previous performance of the processor.

Processing agreements can be between either the distributing agency or a recipient agency and the processor. There are three basic types of agreements:

State Agreement: Under a State agreement, the distributing agency negotiates bids and/or prices, selects the processor and the end product(s) that will be produced, and enters into an agreement with the processor. Any eligible recipient agency may purchase end products from the approved processor.

Recipient Agency Agreement: Under a recipient agency agreement, the recipient agency enters into an agreement with the processor. This kind of agreement requires the approval of the distributing agency. Once approved, the recipient agency can purchase end products from the processor.

Master Agreement: Under a master agreement, the distributing agency enters into an agreement with the processor and only designated eligible recipient agencies may purchase end products from the processor.

WHAT MUST BE INCLUDED IN THE PROCESSING AGREEMENT

It is essential that the processing agreement be accurately completed. The processing agreement must contain the following:

- State distributing agency information (State, agency, agency representative or contact person, address, and telephone number);
- Recipient agency information (if applicable);
- Processor information (the company name, company representative, address, and telephone number);
- Specific information regarding the processor's plant location(s);
- Effective dates (both beginning and ending dates must be specified) of the agreement;
- Information regarding the value pass-through system(s) the processor will use;
- Debarment certification which states that the processor has not been debarred, suspended, proposed for debarment, declared ineligible, or voluntarily excluded from certain transactions with the Federal or State government;
- Specific information that may be required in a "Special Provisions" article of the agreement, such as subcontracting information, dollar value of inventory protection provided by the processor, information regarding by-product credits (particularly for meat and poultry processing), etc.; and
- Names, addresses, titles, and signatures of the authorizing persons who represent the distributing agency and the processor.

WHAT SHOULD BE INCLUDED ON THE END PRODUCT DATA SCHEDULE

An end product data schedule is the document used to establish the amount of donated food that will be contained in each unit of finished end product. It lists the exact quantity of donated food needed to produce the end product and ensures that a specific amount of donated food is contained in the end product. Under the State Processing Program, only approved end products may be marketed; therefore, the sale of an end product **cannot** be made until the end product data schedule has been approved by the distributing agency. The end product data schedule is always provided as part of the agreement package.

There are three different end product data schedules in common use; one for bone-in poultry end products, one for preplated meals, and the other developed for all other donated foods. All sections of the end product data schedule must be completed prior to submission to the distributing agency.

However, if there are portions of this form that are not applicable to the processing of that particular end product, the processor must indicate this on the end product data schedule. On each end product data schedule, processors must include a description of each end product to be processed, the quantity of each donated food being processed, the end product return or yield of donated food, the pricing structure of the end products, the product formulation, and the total batch weight. As part of the product formulation, processors must list any “other” ingredients used to yield a specific number of units of each end product. Distributing agencies may permit processors to specify the total quantity of any flavorings or seasonings that may be used, without identifying the ingredients that are, or may be, components of seasonings or flavorings. Thus, processors can be assured that formulations will not be disclosed, since only the quantity of donated food and total batch weights must be listed on the end product data schedule.

The 100% Yield Factor: The end product data schedule must reflect the actual yield of donated food supported by data contained in the processor’s production and quality control records. For substitutable donated food, 100 percent of the donated food provided to a processor must be contained in the finished end product. For example, if a processor receives 75 pounds of butter, 75 pounds of butter must be contained in the end products. Any loss of the donated food during preparation or production must be replaced with a “like” amount of the same food from a non-donated source (i.e., no donated food losses occurring during production may be debited against the donated food inventory). This production loss must be reflected in the yield percentage on the end product data schedule. With rare exceptions, no end product should have a 100 percent yield of donated food. Processors must ensure that adequate internal control systems are in place to monitor and maintain updated production yield documentation.

Determining the guaranteed minimum return for end products containing non-substitutable donated foods is more complex than determining the yield for substitutable foods. This is more fully discussed in the *Substitution Issues* section of the handbook.

Pre-Approvals: If any changes are made to the product formulation or to the pricing structure, the processor **must** submit a new end product data schedule to the distributing agency for immediate approval. Processors will not be permitted to draw down on their donated food inventory for any new end product data schedules until they receive approval from the distributing agency (inventory drawdown is based on the number of pounds of donated food actually contained in a case of end product).

Additionally, if a processor wishes to add new end products during the agreement year, the processor must submit a schedule to the distributing agency for approval **before** it attempts to sell and report sales of the products.

Furthermore, new end products should be tested by the distributing agency or the recipient agencies before end product data schedules are approved.

Correction to the End Product Data Schedule: The instructions for completing the end product data schedule are found on the reverse side of the form. The contracting agency is responsible for checking all end product data schedules to see that the figures submitted by the processor are accurate. If errors are discovered, the processor should be contacted by telephone and the specific errors identified. At that time, the processor should make the decision as to whether the end product data schedule should be returned for corrections or whether the distributing agency can make the corrections and **initial and date them**. It is very important that corrections (whether made by the processor or the distributing agency) are made to all copies of the schedules.

Proof of Marketability: In the past, there have been instances where processors approved for the State Processing Program did not have sufficient sales to enable them to utilize all the donated foods provided to them in a 6-month period. This occurred because the processor had not generated sufficient business among recipient agencies within the State. The end result was that donated food inventory was carried forward on the processor's books month after month. In order to avoid this situation, processors who wish to participate in the State Processing Program should provide documentation to the distributing agency that a market exists within the State for the finished end products they wish to sell to recipient agencies. Examples of proof of marketability could be copies of bid awards and/or letters of intent to purchase from eligible recipient agencies located within the State. Processors may be required to provide this documentation as part of the processing agreement submitted to the distributing agency. Processors may also be required to provide evidence to prove they can accept and store minimum truckload quantities of donated food.

Once the processor is approved for participation in the State Processing Program and receives donated food, the processor must actively market and sell the end products to eligible recipient agencies. The processor is expected to fully utilize the food inventory on hand and report sales to the distributing agency. Furthermore, the inventory level of each donated food in the processor's storage facility may not exceed a 6-month supply, unless the processor has requested and received **written** approval from the distributing agency to maintain a higher inventory level.

Inventory Protection: In accordance with Section 250.30 (c)(4)(viii)(B) of the State Processing regulations, before receiving any donated food for processing, all food processors must furnish a performance supply and surety bond, an irrevocable letter of credit (LOC), or establish an escrow account sufficient to cover the amount of inventory **on hand and on order**. The surety company from which the bond is obtained **must** be listed in the most current Department of Treasury Circular 570, Companies Holding Certificates of Authority as

Acceptable Sureties on Federal Bonds and as Acceptable Reinsuring Companies. This Circular is published on July 1 of each year and may be obtained through the Internet at:

<http://www.ustreas.gov/treasury/bureau/finman/c570.html>

Establishing the Amount of Coverage: For new processors, the amount of coverage must be sufficient to cover the value of the first food order. Since most food orders are in truckload quantities, the initial bond, LOC amount, or escrow account must be equal to the value of one truckload for each commodity ordered. For example, a processor ordering cornmeal and butter must obtain, at a minimum, a bond of \$44,928 ($\$.1025/\text{pound} \times 43,200 \text{ pounds of cornmeal} + \$1.0125/\text{pound} \times 40,000 \text{ pounds of butter}$).

For processors with a history of participation in the State Processing Program, the amount of inventory protection must cover the amount of inventory on hand and on order, taking into consideration donated food usage up to the point of delivery. The distributing agency will determine the maximum amount of inventory to be covered by the bond/letter of credit/escrow account to see that all the donated inventory is protected.

State distributing agencies have been instructed to not order food if the inventory protection is insufficient to cover the value of inventory on hand and the requested food order, or when the food order would increase inventory levels above the maximum allowable inventory level. Section 250.30(n) of the regulations limits the amount of donated food a processor may hold in inventory to a 6-month supply, based on average monthly usage, unless the distributing agency has approved a higher inventory level based on justification provided by the processor. This established level represents the maximum allowable inventory level. Processors may choose to provide sufficient bonding to allow them to operate at this level. Maintaining a 6-month supply provides processors with maximum flexibility in meeting their clients' demands for approved end products during the period of the agreement, especially at the beginning of the agreement year when the need for start-up inventories is most crucial. However, it is up to each processor to determine how much inventory up to the maximum allowable inventory level they wish to keep on hand and to ensure that inventory protection levels are in place accordingly.

What is the Processor's Liability under these Sureties: Processors are liable for the full value of all donated foods received under processing agreements each year and must maintain records to demonstrate compliance with such agreements for up to three years from the end of each agreement period, or longer if required for unresolved audits or investigative findings. If a processor's noncompliance with any aspect of the processing agreement results in a claim and the processor fails to honor such claim, the distributing agency must "call in" the bond/LOC/escrow account by transferring the liability from the processor to the bonding company or bank for up to the full value of the bond/LOC/escrow

account. Prior to “calling in” the bond/LOC/escrow account, however, processors will be offered every opportunity to honor any claims.

Are Continuation Certificates Acceptable: Most continuation certificates are not designed to provide the ongoing level of independent coverage required for each processing agreement. Because continuation certificates are basically intended to extend the life of the bond, and not the specific amount of protection offered by the bond, continuation certificates should not be used to meet the bonding requirements of future processing agreements. Processors should submit a new bond **or** a bond renewal for every year they wish to participate in the Program.

Finally, if a processor elects to provide inventory protection through an LOC, the processor must ensure that the following clause is included in the LOC format: “It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for one year from the expiration date hereof, or any future expiration date, unless 30 days prior to any expiration date we notify you by registered mail that we elect not to consider this Letter of Credit renewed for any such additional period.”

LOCs must be in effect for the entire period of the processing agreement to which they pertain and should remain in effect for an additional six months following the expiration date of the agreement. For example, if a processor’s agreement is in effect from July 1, 1997, through June 30, 1998, the LOC should not expire **before** January 31, 1999. However, the LOC may be released if the distributing agency is **completely** satisfied with the reconciliation report submitted by the processor.

Can a Surety Bond or LOC be Printed On Two Separate Pages? Yes. Both surety bonds and LOC’s can be printed on one or two pages. For legal reasons, the signatures must be on the bond.

Bond Guidelines: All food processors participating in the State Processing Program should be required to provide “**New**” or “**Renewed**” bonds each agreement year with a minimum value to cover food orders and existing inventories. This will be the case whether the processing agreement is newly approved or extended. At a minimum, the following information must be included in the bond:

- Principal’s name (processing company);
- Signature of authorized processing company official (with witnessed signature);
- Title of authorized company official;
- Surety name (i.e., bank, insurance company);
- Amount of bond;
- Date of bond issuance;

- Effective date of bond must precede or coincide with the effective date of the agreement;
- Expiration date (not to expire before June 30, of any agreement year);
- Signature and title of surety official (with attester's signature);
- Surety company must be listed in the most current Department of Treasury Circular 570, *Surety Companies Acceptable on Federal Bonds*; and
- Bond Number.

Note: Please ensure that the Attorney-in-Fact that signs the bond also signs the Power of Attorney where applicable.

LOC Guidelines: If food processors participating in the State Processing Program wish to utilize an "irrevocable" LOC instead of a bond, at a minimum, the following information must be included in the LOC:

- Principal's name (processing company);
- Signature of authorized processing company official (with witnessed signature);
- Title of authorized company official;
- Surety name (i.e., bank, insurance company);
- Amount of LOC;
- Date of LOC issuance;
- Effective date of LOC must precede or coincide with effective date of end product data schedule;
- Expiration date;
- Signature and title of official (with attester's signature) and
- All LOCs **must** include the following provision:

"It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for one year from the expiration date hereof, or any future expiration date, unless 30 days prior to any expiration date we notify you by registered mail that we elect not to consider this Letter of Credit renewed for any such additional period."

Selection of Value Return Systems: The processing of donated food can usually be incorporated into the processor's normal manner of doing business, including production, pricing, and delivery of the end product. The specific value of the donated food **must** be the designated USDA value. The processor must ensure that the full value of the donated food contained in the end product is passed to the recipient agency. Processors can select any of the value pass - through (VPT) systems described below; however, the distributing agency reserves the right to disallow continued use of a VPT system if poor performance is indicated.

Direct Discount Sale - The recipient agency takes delivery of the finished end products and is invoiced directly by the processor at a net case price that reflects the full value of the donated food contained in the end products purchased.

Direct Refund Sale - The processor invoices the recipient agency directly for the commercial/gross price of the end product. The recipient agency submits a refund application to the processor within 30 days from the close of the month in which the sales were made. Within 30 days of receipt of the recipient agency's refund application, the processor must issue a payment directly to the recipient agency in an amount equal to the value of donated food contained in one case of end product, multiplied by the number of cases delivered to and accepted by the recipient agency. If the total refund due for any one quarter is \$25 or less, recipient agencies may submit the accumulated refund applications quarterly and processors may pay the accumulated refunds quarterly.

Indirect Refund Sale -Processors sell end products to distributors at the commercial/gross price of the end product. Distributors then sell end products to recipient agencies at the commercial/gross price, plus delivery costs. Each recipient agency must then submit a refund application to the processor within 30 days of the receipt of the end products. Within 30 days of receipt of the recipient agency's refund application, the processor must issue a payment directly to the recipient agency in an amount equal to the value of donated food contained in one case of end product, multiplied by the number of cases delivered to and accepted by the recipient agency.

Indirect Discount Sale ("Hybrid") - This system is referred to as the "hybrid" system because it combines features of the discount and the refund VPT systems. The processor sells end products to a commercial distributor at the gross/commercial price. The distributor, in turn, sells the products to eligible recipient agencies at the net case price (i.e., the gross/commercial price less the discounted value of the donated food contained in each case purchased by the recipient agencies) plus the distributor's markup for each case of product. Within 30 days from the close of the month in which the sales were made, the distributor must apply to the processor for a refund or credit for the value of the donated food in the end products. The processor then must provide a refund to the distributor within 30 days of receipt of the application for all valid sales to eligible recipient agencies. The processor must ensure that the distributor provides discounts of equal value to eligible recipient agencies as established in the processing agreement and the applicable end product data schedule(s).

If delegated by the distributing agency, processors using the "hybrid system" must also have a verification system in place to confirm sales reported by distributors. As part of this system, the processor must verify a statistically valid sample of reported discount sales made by distributors in a manner that ensures a 95 percent confidence level. This includes submitting written reports to the distributing agency as an attachment to the December and June performance

reports, summarizing the verification results and submitting corrective action plans to the distributing agency to identify any invalid sales reported by the distributor. The distributing agency must review the processor's findings and select a random sub-sample of at least 10 percent of all sales verified by the processor and reverify the sales by contacting the recipient agencies by telephone or through written correspondence. The distributing agency is then required to submit a copy of the processor's review report and findings and the results of its reverification efforts to the appropriate FNS Regional Office.

Other Systems: Processors are permitted to use alternate VPT systems if approved by the distributing agency and FNS. These systems must comply with the sales verification requirements outlined in 7 CFR Part 250.19(b)(2) of the Food Distribution Program regulations or alternate verification system as approved by the or FNS. Additionally, FNS may consider the paperwork and resource burden associated with alternate VPT systems when considering approval and reserves the right to deny the approval of systems that are more labor intensive than those permitted by the regulations and provide no greater accountability than traditional systems.

The section on Monitoring Activities discusses the process used to verify sales in both the hybrid system and the alternate VPT system.

Fee-For-Service Arrangements: The processing of meat and poultry into finished end products are traditionally performed under fee-for-service arrangements. The definition of fee-for-service is the price by pound or by case that represents a processor's cost of ingredients (other than the donated food), labor, packaging, overhead, and other costs incurred in the conversion of the donated food into the end product. Under fee-for-service arrangements, a discount or refund per case is not established; consequently, there is not a credit for the value of the donated food. The net price is based on a charge per pound or per case for processed finished product. Additionally, processors are responsible for returning the market value of any by-products (less costs) which result from processing meat and poultry.

Since the majority of end products produced under fee-for-service agreements contain meat or poultry, care must be taken to ensure that end products are sold only to outlets eligible to receive these donated foods and the value of the meat or poultry must be credited against the appropriate outlet's commodity entitlement. Also, meat and poultry products, which are non-substitutable donated foods, must be clearly labeled "Contains Commodities Donated by the U.S. Department of Agriculture. This Product Shall Be Sold Only to Eligible Recipient Agencies."

If by-products are produced as the result of converting donated food into finished end products, processors must give credit for by-products (after the processors'

expenses are deducted from any sale of these by-products) through a reduction in the fee-for-service price by:

- a reduction in the fee-for-service by a specific dollar value amount reflected in the agreement; or
- by identifying by-product credits directly on the billing invoice.

End products produced under fee-for-service agreements may be delivered and invoiced to recipient agencies in one of the following ways:

- The processor delivers the end products directly to the recipient agency and bills the recipient agency for the agreed upon fee-for-service plus the delivery charge; or
- Delivery is made by commercial distributors. Processors may not sell end products directly to distributors at the fee-for-service price.
- Two options for arranging payment for end products are:
 - A dual billing system whereby the recipient agency is billed by the processor for the fee-for-service and the distributor bills the recipient agency for storage and delivery of end products; or
 - The processor makes arrangements with a distributor for delivery of end products on behalf of the recipient agency. In this situation, the processor's invoice must include both the processing fee and the distributor's charges as separate, clearly identifiable charges.
 - contract;
 -

Contract Value of Donated Food: The contract value is the price assigned by USDA to a donated food which reflects USDA's current cost to acquire, package, and distribute donated foods. The contract values are used for a many reasons, including the following:

- determining the amount of refund or discount due to recipient agencies for finished end products;
- determining the value of the surety bond, escrow account, or LOC needed by the processor;
- determining the costs of replacement for production or commodity losses; and
- determining the amount of money the processor would owe the distributing agency or recipient agency for failure to meet the guaranteed minimum return.

Each year, FNS provides distributing agencies with the *Commodity File*, issued in mid-January, which lists USDA's current cost for acquiring each donated food. These values must be used in processing agreements for the upcoming agreement year (beginning July 1 of the current year and ending June 30 the following year). All processing agreements, regardless of the date the agreements were approved, must use the value contained in the mid-January *Commodity File*. However, FNS reserves the right to adjust commodity values during the agreement year if it is determined that USDA's acquisition costs have

significantly changed. If this is the case, **all** agreements involving the particular commodity must be amended to reflect the new commodity value.

Containers - Processors are responsible for returning all funds received from the sale of donated food containers. The distributing agency will determine whether the funds will be returned either to the distributing agency or recipient agencies in the form of a cash payment or applied as a credit. If the distributing agency permits credit, the processor must provide a summary of the pricing information to the distributing agency as soon as possible after agreement approval. If the processor sells containers for commercial reuse, all USDA restrictive legends or markings must be completely and permanently obliterated or removed by the processor prior to resale.

By-Products - Salvageable material, not utilized in the production of end products, that is produced or derived from the manufacturing procedure used to process the donated food, must be disposed of in a manner as to realize the greatest value possible for the material. The distributing agency must make the decision as to how the material should be handled. In most cases the product is handled as follows (at the option of the distributing agency):

- The processor can accumulate the by-product and return it to the distributing agency or recipient agency; or
- The processor can return all funds received from the sale of salvageable by-product material. The funds can be paid to the distributing agency or the recipient agencies. Again, the return of the funds can be in the form of a cash payment or a reduction in the selling price of the end product based on the following:
 - The actual value received from the sale of the by-product; or
 - The fair market value of the by-product at the time it is further processed or refined by the processor minus any costs that the processor incurs in transforming the byproduct to a salable product.

Whichever method is selected, instructions for the disposition any by-products must be clearly spelled out in the processing agreement. The same procedures apply to the handling of donated food containers.

Subcontracts: Processors are not permitted to assign and/or delegate any of their duties or responsibilities to process donated food under the agreement without the prior written consent of the distributing agency. This includes subcontracting agreements or any other arrangements to process donated food. If a subcontract is approved, the processor remains responsible as the prime contractor to ensure that the donated food is accounted for and processed according to the terms and conditions contained in the processing agreement. The processor is obligated to inform the subcontractor of all requirements of the agreement. A subcontractor agreement must be filled out for each subcontractor and included with the primary processing agreement when submitted to the

distributing agency for approval. If donated food is shipped directly to a subcontractor; appropriate arrangements will have to be made. Also, it is advisable that the provisions or terms of the subcontract clearly spell out the record-keeping requirements of the subcontractor (i.e., production records, quality control records, sales records, inventory records for donated food, etc.).

Substitutable Donated Foods: Donated foods are divided into two main categories: substitutable and non-substitutable. Substitutable foods are those donated foods which may be substituted, interchanged, or commingled in storage and production with a commercial food of the same generic identity and of equal or better quality. The following donated foods are currently classified as substitutable under the State Processing Program: butter, cheese, corn grits, corn meal, flour, macaroni, nonfat dry milk, peanut butter, peanut granules, roasted peanuts, rice, rolled oats, rolled wheat, shortening, vegetable oil, spaghetti, and any other foods that FNS specifically approves as substitutable. Processors are not required to obtain advanced approval from the distributing agency to substitute commercial products for donated foods classified as substitutable by FNS.

Processors must maintain documentation which proves that the commercial foods being substituted for donated food are of U.S. origin, are of the same generic identity, and are identical or superior to the donated food specification as evidenced by certification performed by or acceptable to the applicable Federal acceptance service.

Non-Substitutable Foods: Non-substitutable foods are all other donated foods provided by USDA that are not listed in the paragraph above. Non-substitutable foods may not be interchanged, commingled, or substituted with commercial foods in storage or in the manufacturing of the end product. However, processors may request FNS to allow non-listed donated foods to be considered as substitutable foods. To assist FNS in deciding approval, processors which request substitution of a non-listed donated food must submit copies of their purchase specifications to FNS. FNS will then determine whether the commercial food is of equal or superior quality to the donated food and is generically identical to the donated food.

When non-substitutable foods are approved by FNS as substitutable, such approval is granted only to that processor requesting the approval for only that particular commodity. Furthermore, permission to substitute only remains in effect for the duration of the agreement year in which the substitution was granted. If the same processor had an agreement the following year and wished to substitute the same commercial product, that processor would have to reapply to FNS.

Processors who substitute commercial foods for donated foods are responsible for maintaining documentation that their normal commercial purchases have not

been reduced as a result of participation in the State Processing Program. Additionally, processors must be able to document that their commercial purchases of ingredients are adequate to cover production needs under the 100 percent yield requirement.

See the Substitution Section, which provides further details on the handling of substitutable and non- substitutable foods.

Use of Additives: Because processors are only allowed to use ingredients in their end products that have been approved by the Food and Drug Administration, FNS does not restrict the types of ingredients that can be added to end products containing donated food. However, distributing agencies have the right to either reject specific end products or not enter into agreements with processors based on the commercial ingredients contained in the end products made with donated food. Processors are required to include a description of each end product, the quantity of each donated food being used, and the identification of any other ingredients which are needed to yield a specific number of units of each end product. Thus, any commercially acquired ingredients, including additives, must be clearly identified on the end product data schedule. In order to ensure that “secret” recipes are protected, distributing agencies permit processors to specify the total quantity of any flavorings or seasonings which may be used, without identifying the ingredients which are, or may be, components of seasonings or flavorings. In this way, only the quantity of donated food and total batch weights will be listed on the end product data schedule. By identifying the commercial ingredients contained in end products using donated food, distributing agencies can decide whether a particular end product is a good choice for the recipient agencies to serve in their meal service operations.

Additives such as vegetable protein products and alternate cheese products have been incorporated into end products containing donated food for many years. If these additives are used in the manufacturing process of Child Nutrition Labeled products, they must be used in accordance with the regulations governing the National School Lunch Program, Summer Food Service Program, and Child and Adult Care Food Program, respectively 7 CFR Parts 210, 225, and 226, Appendix A.

Quality Control System: As part of the processing agreement, the processor must develop and maintain a Quality Control (QC) plan or system for the duration of the processing agreement. At a minimum, the QC plan should provide for the following:

- The processor must ensure that all donated food and ingredients which are added to the donated food are handled and processed in a sanitary and safe manner to ensure that a wholesome end product is delivered to the distributing agency or the recipient agency.

- The processor must store, handle, transport, and deliver finished end products in a safe and sanitary manner at the recommended temperature according to generally accepted commercial practices within the processor's industry for the specific donated food and end product(s) covered in the processing agreement.
- The processor must ensure that all end products produced under the processing agreement be processed according to the health and sanitation standards for plant facilities and food processing established by the locality or State in which the processor's plant is located or by the applicable Federal standards, whichever is higher.
- At the option of the distributing agency, samples may be pulled from the delivered end product for laboratory testing. Costs of such tests must be paid by the processor only if the product sample tested fails to meet either the agreement specifications or quality and wholesomeness standards.
- The processor must maintain end product batch identification. Each case of end product must be labeled as to the particular batch in which it was produced.
- The processor must ensure that if vegetable protein products or cheese alternate products are used in any end products produced for the National School Lunch Program, Summer Food Service Program, or Child and Adult Care Food Program, respectively, they must conform to 7 CFR Part 210, 225, or 226, Appendix A.
- The processor must obtain approval through procedures established by FNS, USDA's Food Safety Inspection Service, U.S. Department Of Commerce's National Marine Fisheries Service and/or other applicable Federal agencies of all labels which make any claim with regard to an end product's contribution toward meal pattern requirements of any Child Nutrition Program.
- The processor must ensure that the end products are made in accordance with the processing agreement specifications, e.g., information that has been provided on the end product data schedule.

Grading Requirements (Meat and Poultry Only): All donated meat and poultry processing must be performed under the supervision of an Agricultural Marketing Service (AMS) acceptance service grader. This supervision guarantees that the end products are produced using donated meat or poultry and, if applicable, that the products produced meet the specifications as listed on the end product data schedule and the processing agreement. The costs to perform the meat and poultry grading services must be borne by the processor.

Debarment Certification: In an effort to curb fraud, waste and abuse, Presidential Executive Order 12549 requires Executive departments and agencies of the Federal Government to participate in a government-wide system to suspend and debar any individual and/or entity, including processors, from receiving Federal government assistance or benefits if they are found to be causing damage to any federally administered program. Once a Federal

department or agency takes suspension or debarment action, that individual and/or entity may not receive benefits or assistance from **any** Federal program.

Under USDA's nonprocurement debarment and suspension regulation (7 CFR Part 3017, Section 3017.510), FNS has the authority to suspend or debar an individual and/or entity from participation in the State Processing Program if they are suspected of conducting questionable or illegal activities in that program. In order to protect the interests of USDA, FNS may place any individual or entity on suspension while FNS conducts an in depth review of any questionable activities. When FNS debars an individual and/or entity from the State Processing Program, that individual or entity is ineligible to receive program assistance and benefits until the period of debarment expires. FNS has the authority to use its resources to identify situations in which suspension or debarment may be a necessary action to protect the public interest or to gather substantive evidence, generally through investigations, to prove one or more of the causes necessary to impose a suspension or debarment action.

Individuals or entities can be debarred from receiving Federal assistance and/or benefits for various reasons, including the following:

- Conviction of or civil judgment for:
- A fraudulent act or a criminal offense in connection with obtaining, attempting to obtain, or performing a public or private agreement or transaction;
- A violation of Federal or State antitrust statutes, including those prescribing price fixing between competitor, allocation of customers between competitors, and bid rigging;
- The act of embezzlement, theft, forgery, bribery, falsification or destruction of records, making false statements, receiving stolen property, making false claims, or obstruction of justice; or
- An offense which indicates a lack of business integrity or business honesty that seriously and directly affects the present responsibility of a person.
- Violation of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as:
- A willful failure to perform in accordance with the terms of one or more public agreements or transactions;
- A history of failure to perform or of unsatisfactory performance of one or more public agreements or transactions;
- A willful violation of a statutory or regulatory provision or requirement applicable to a public agreement or transaction; or
- Failure to pay a single substantial debt, or a number of outstanding debts (including disallowed costs and overpayments, but not including sums owed the Federal Government under the Internal Revenue Code) owed to any Federal agency or instrumentality, provided the debt is uncontested by the debtor or, if contested, provided that the debtor's legal and administrative remedies have been exhausted.

Destination Data Information: Included in the agreement package is a copy of the *Destination Data For Delivery of Donated Food (Form FNS-7)*. This form is used to supply information about destination receiving points used by the distributing agencies for the receipt and distribution of donated food and other information needed for managerial purposes. Instructions on how to properly complete the form are found on the reverse side. The distributing agency may complete this form except for Blocks 2, 5, 6, and 7 before mailing the form to the processor. Processors must submit a separate form for each location where donated food must be shipped. Processors must not complete Blocks 15 and 16 as these blocks are for distributing agency use.

Health Inspection Report (Optional): Processors must store, handle, transport, and deliver end products in a safe and sanitary manner at recommended temperatures according to generally accepted commercial practices within the processor's industry for the specific donated food and end products covered under the agreement.

The agreement also requires the processor to ensure that all end products produced under the agreement must be processed according to the health and sanitation standards for plant facilities and food processing established by the locality or State in which the processor's plant is located or by the applicable Federal standards, whichever is higher.

The distributing agency may wish to request that the processor provide a complete copy of a Health Inspection Report for each storage site and the plant where the actual manufacturing will take place. This may be requested during the agreement approval process.

End Product Labeling Requirements:

All processed end products must meet the labeling requirements of the Food Safety Inspection Service (FSIS) (for meat and poultry products) and/or the Food and Drug Administration (FDA). There are three conditions, however, which require special labeling of end products produced under the State Processing Program:

- The labeling of shipping containers of end products;
- The labeling of end products containing vegetable protein products and cheese alternates; and
- Child Nutrition (CN) Labeling.

When end products are made with non-substitutable donated food, the processor must clearly label the exterior shipping containers with the following statement: "Contains Commodities Donated by the United States Department of Agriculture. This Product Shall Be Sold Only to Eligible Recipient Agencies." Whenever possible, the individual wrapping or containers of these end products should also carry this statement.

Vegetable Protein and Cheese Alternate Products:

Vegetable protein products used in end products which are served in USDA's Child Nutrition Programs to resemble and substitute, in part, for meat, poultry, or seafood must comply with the labeling and nutrition specifications set forth in the regulations governing the National School Lunch Program, Summer Food Service Program, and Child and Adult Care Food Program, respectively, 7 CFR Parts 210, 225, and 226, Appendix A. These end products must have a label containing the following statement: *"This product meets USDA-FNS requirements for use in meeting a portion of the meat/meat alternate requirement of Child Nutrition Programs."* This statement must appear on the principal display panel area of the package. Cheese alternate products must bear a label that essentially makes the following statement: *"This product meets USDA-FNS specifications for cheese alternate products."* In those States where State or local law prohibits the wording specified, a legend acceptable to either the State or local authorities and FNS must be substituted. The labeling of the product must comply with applicable regulations prescribed by FDA, USDA, or other government agencies. The term "cheese alternate products" denotes a class of products and not a product name.

Child Nutrition (CN) Labeling: When a processor makes any claim with regard to an end product's contribution toward the meal requirements of any Child Nutrition Program, the processor shall follow procedures established by FNS, FSIS, the National Marine Fisheries Service of the U.S. Department of Commerce or other applicable Federal agencies for approval of such labels.

Distribution of Agreement Information: All parties to the processing agreement must retain a copy of the signed agreement and any addenda for their records. This applies to all agreements whether they were approved by the recipient agencies or the distributing agency. The distributing agency is required to provide a signed copy of the processing agreement and any addenda to the FNS Regional Office. Because the processing agreement is considered a public record, the distributing agency or the FNS Regional Office will provide a copy of the agreement to any person upon request as a public record under the applicable Federal or State "Freedom of Information (FOI)" laws. However, because the FOI laws exempt the disclosure of information containing trade commercial or financial data, those portions of the processing agreement which contain the listing of ingredients contained in the processed end products and the price and yield schedules need not be made available as part of the public record (in accordance with Exemption 4 of the FOI Act, 5 U.S.C. 552(b)(4)).

All parties to the processing agreement, as well as the FNS Regional Office, must retain a copy of the processing agreement and any addenda for a period of three years from the close of the Federal fiscal year to which the processing agreement pertains. However, in instances where claims actions and/or audit

findings have not been resolved, the records must be retained as long as required for the resolution of such actions or findings.

Copies of the actual agreement are rarely provided to the recipient agencies. Distributing agencies, for the most part, provide information contained on the end product data schedule to assist the recipient agencies in deciding which processor they will buy from and which end products they will select.

FOOD ORDERING:

Once a processor's agreement has been approved and transmitted to the Regional Office, the processor may request orders for donated food. The distributing agency must have processing agreements in place before planned orders will be purchased. Before the orders are requested, it is also recommended that the processor submit the required performance bond, an irrevocable letter of credit, or an escrow account. The distributing agency may place an order without the bond, letter of credit, or escrow account but must ensure that one is submitted prior to the delivery of the donated food.

Prior to the beginning of each school year, the recipient agencies are allowed to designate how many cases of end product they would like to have diverted to the processor of their choice by filling out the processing order form. Prior to filling out the order form, the recipient agency should contact the processor/broker to determine which end-products they want to order and how much product they need to send. IT IS EXTREMELY IMPORTANT THAT THE RECIPIENT AGENCIES KNOW EXACTLY HOW MUCH PRODUCT THEY ARE GETTING BACK.

Upon receipt of all processing order forms from recipient agencies, the orders are totaled and truckloads are established. If there are not enough orders to make a full truck, the distributing agency can combine with another state to make a full truck if available. If there is not enough interest to divert product to a certain processor, the recipient agency is notified and given the opportunity to choose another processor.

The distributing agency should require the processor to place all requests for food orders in writing. If the decision to order food is based on a telephone conversation, the distributing agency should insist that the request be confirmed in writing in order to maintain the information in the company's file.

Destination Data Information (FNS-7):

The distributing agency must ensure that the *Destination Data For Delivery of Donated Foods (Form FNS-7)* is completed. The processor may need to supply some of the information such as the receiving points for the receipt and distribution of donated foods. Instructions on how to properly complete this form

are discussed in the *Agreement Approval* section of this handbook. This form must be completed in order to obtain an entity code necessary for processing food orders through the Kansas City Commodity Office (KCCO). If any of the information on the form changes, e.g., destination address, contact name, the “change” box in the “Type of Action” entry must be checked and the same entity code will be retained. However, if a processor’s name changes, the “new” box in the “Type of Action” entry must be checked and a new entity code will be assigned. If a processor’s agreement is terminated, the “cancel” box in the “Type of Action” must be checked.

Food Order/Bond Worksheet:

FNS has developed a worksheet that can be used by distributing agencies to assist them in determining when and if to actually place an order for a processor. (This worksheet may also be used to calculate the amount of inventory protection needed for establishing a bond.) The steps to follow include:

Determine Inventory Liability

- Begin with the processor’s current inventory balance (from the last performance report submitted);
- Add food orders already placed but not delivered;
- Add amount of donated food requested;

This is the total amount of inventory under consideration.

Determine Sales Volume

- Determine total sales year-to-date;
- Determine average monthly sales figure;
- Project sales to be reported prior to the receipt of donated food;
- Determine estimated inventory at time of delivery of donated food;

Calculate maximum 6-month inventory level.

Calculate Bond Coverage

- Take the beginning inventory;
- Add orders placed but not received;
- Add order requested;
- Subtract the projected reported sales (prior to delivery)

Equals maximum inventory level expected. Then multiply this figure by the contract value of the donated food. (Compare this figure to the figure for bond coverage)

The key points to remember in these exercises are to determine the maximum amount of inventory to be covered by the bond/letter of credit/escrow account to ensure that the inventory is protected and to ensure that the processor has no more than a 6 month supply of donated food on hand. If inventory is over the 6-month level, steps must be taken to reduce the inventory or the distributing agency must issue the processor written permission to exceed the 6 month level.

Processor Notification: Processors are given the allocation breakdown for each recipient agency. The recipient agencies are notified of the exact amount of commodity delivered to the processor and when it was delivered via the Notice of Arrival Form (KY-FD-2). If at that time the recipient agency has any questions about the quantity of commodities being delivered, they should contact the distributing agency.

The processor shall deliver no more than three items to the recipient agency's distributor at any one time, unless agreed upon by processor and distributor.

The processor must make an appointment with the recipient agency's distributor 24 hours in advance of delivery of the finished product(s) and also notify the recipient agency of the delivery date.

The processor shall provide information such as: item description, case weight, name of recipient agency, number of cases shipped for each recipient agency, etc., on all processed items delivered to the distributor.

The recipient agency must send the Notice of Delivery of Donated Foods to Schools (KY-FD-3) to the distributor within 24 hours of notification from the processor. Recipient agencies have 30 days free storage for processed items.

Completion of Receipt Forms: The distributor records the receipt of shipment on the Distributor's Receiving Report for USDA Donated Foods Form (KY-FD-6). All documents relative to receiving of products at the warehouse, including the Bill of Lading, shall be forwarded to the distributing agency immediately upon unloading and verification of receipts.

Over, Short, Damage Report: It is important for processors to carefully check each shipment to assure that their food order is complete and has been delivered in good condition. If there is a problem with the shipment, processors are required to submit an FNS-57, *Report of Shipment Over, Short, and/or Damaged (OS&D)* to the distributing agency, which will then submit the form to the KCCO. In addition, the OS&D report is required if the total number of units of end product delivered is not the same as the total units on the KC-269A or if the net weights do not agree. It is imperative that any damages, shortages, or overages are noted on the driver's delivery receipt prior to signing for the delivery. The subsequent completion of the FNS-57 will not nullify a previously signed clear delivery receipt.

Procedures For Reporting Out of Condition Food At Receipt:

Occasionally, the Regional Office will notify the distributing agency that a shipment is to be put on hold. The distributing agency must inform the processor immediately and follow the instructions of the Regional Office that follow the notification. If part of the shipment is damaged at the time of unloading, the processor must notify the distributing agency immediately. The distributing agency is to consult with the Regional Office when guidance is needed or if USDA inspection of the food is required. Damage is reported when a donated food is unloaded in less than perfect condition (i.e., torn bags, crushed cartons, leakage, etc.). If damage has occurred, the condition of the shipment must be reported to the delivery carrier or his agent before the entire shipment is unloaded. Any damaged cargo that is determined suitable for human consumption shall be salvaged and accepted for program use. The distributing agency will provide guidance about what to do with the remainder of the shipment. When a shipment is delivered and all or a major portion of the shipment is apparently off-grade, out-of-condition, or damaged, the processor shall contact the distributing agency who will report all the facts pertinent to the arrival condition to the Regional Office. The Regional Office will provide disposition instructions to the distributing agency. The distributing agency shall obtain an inspection by a qualified person as determined by the Regional Office. Should the inspection confirm the findings of the initial examination, the shipment shall be held and full details reported immediately to the Regional Office. At a minimum, the report shall include the following information:

- Delivery Order (DO) number, contract number, and Notice of Delivery (ND) number;
- Rail car number and initial, piggyback trailer number, or truck/trailer identification;
- Name of shipper, origin, and date of shipment;
- Quantity and description of food in the shipment;
- Date and time shipment received;
- The problem that occurred and the quantity of donated food affected;
- Current status (unloaded, trailer left warehouse, etc.);
- Cause of condition, only if such cause is obvious (i.e., wrecked container, fire, temperature unit not operating);
- Protective services provided;
- Name, title, and telephone number of person who made inspection. If an inspection report was prepared, a copy of the report must be forwarded.
- A record of the name and location of the carrier's agent who was notified along with the agent's response, including the time and date. The name of the persons making the notification should also be included
- Name of the person making the notification;
- Specific location with the transportation conveyance;
- Pictures of the damage, if available;
- Person and telephone number to contact regarding shipment; and

- For perishable foods, the information required in Item 26 of the FNS-57.

Out-of-Condition Food Identified After Receipt: If food at the processor is determined to be out of condition some time after the receipt but before processing, the DA shall provide all pertinent facts to the Regional Office for guidance. If it is suspected that the processor is responsible for the food going out of condition, the DA must follow the claims procedures in FNS Instruction 410-1, Rev. 1, and any appropriate FNS policies. Any food determined to be out of condition after processing is the responsibility of the processor and the DA.

Direct Shipment Versus Backhaul: Ordering food for shipment directly to the processor, rather than having donated food backhauled from recipient or distributing agencies' warehouses, can result in considerable cost savings for the recipient agency. For instance, the DA/RA will not have to pay additional transportation costs from their facilities to the processor. Whenever commodities have to be backhauled to a processor from local storage facilities, the recipient agencies purchasing the end products pay for the additional transportation charges through the increased cost of the end products. Also, by processing donated foods in truckload quantities rather than small lots, processors can achieve greater yields in the production of end products. They can use their equipment and labor at maximum efficiency. Furthermore, end products produced from donated food shipped directly to the processor may be superior to those made from donated foods that may have been held in storage under less than optimal conditions.

Arranging Direct Shipments: To arrange orders for direct shipment to a processor, the distributing agency should do the following:

- Enter into a processing agreement;
- Determine if the processor can accept truckload quantities of donated food;
- Determine what recipient agencies wish to have commodities processed by the particular processor and how much they want processed;
- Calculate full truckload quantities for each processor;
- Order the appropriate quantities of donated food through FNS;
- Notify the processor of the incoming quantities of donated food;
- Notify the processor of each recipient's fair share of the raw donated food.

Inventory Controls:

There are many challenges that can arise in managing the inventory being maintained by a processor. Many times even a single shipment of donated food will put the processor over the 6 month inventory limit. Should this occur, the Distributing Agency has the following options:

1. With the approval of the Regional Office, transfer the donated food to another processor or to another DA being served by the current processor. The

distributing agency may request an entitlement adjustment for the transfer if the food is received and transferred in the current year.

2. Have the processor “buy down” the inventory to a proper level according to the processing agreement. Follow the instructions in FNS Instruction 410-1 Rev.1 and the appropriate FNS policies for establishing a claim against the processor.
3. Consider the ramifications of allowing the processor to retain more than a 6 month inventory. If acceptable, then give the processor written permission to maintain more than a 6 month supply of the donated food.

Processors should make every possible effort to *avoid* going into a negative inventory status. When this does occur, the distributing agency should work with the processor to take action immediately to resolve the problem. If donated food orders were delayed, causing the processor to use commercial inventory to ensure a constant supply of product to the recipient agencies; the distributing agency should notify the processor that:

- donated food is on order and the processor can offset his negative inventory upon receipt of the donated food or
- donated food cannot be obtained so the processor should **not** offer end products at the price discounted for the value of the donated food until further notice.

If the processor continues to sell products at the discounted price to recipient agencies, he should be notified that he is going into negative status at his own risk. There is no guarantee that the negative inventory will be replaced.

MONITORING ACTIVITIES

Performance Reports:

Processors must submit performance reports to distributing agencies that outline the processing activity for that month. This report should include year-to-date totals of all processing activity. Processors must ensure that each monthly performance report is postmarked no later than the final day of the month following the reporting period. The September, December, and March reports will be considered Quarterly reports and the June report will be considered the annual reconciliation report. The June report should be postmarked no later than 60 days from the close of the contract year. The monthly performance report must include the following information:

- A list of all recipient agencies purchasing end products under the agreement;

- Donated food inventory at the beginning of the reporting period;
- Amount of donated foods received during the reporting period;
- Amount of donated foods transferred to and/or from existing inventory;
- Amount of donated foods processed during the report period;
- Number of units of approved end products, by product code, processed for each eligible recipient agency during the reporting period;
- Donated food inventory at the end of the reporting period;
- This certification statement: I certify that sufficient donated foods are in inventory or on order to account for the quantities needed for production of end products approved under the donated foods processing agreement. I additionally certify that adequate quantities of commercially purchased foods are on hand or on order to meet production requirements for commercial sales. The above information is correct to the best of my knowledge and belief.
- When sales verification has been delegated to the processor pursuant to Section 250.19(b)(2) of the Food Distribution Program regulations, sales verification findings must be reported as an attachment to the December and June performance reports in whatever format the distributing agency deems necessary. Non-compliance with this requirement may result in agreement termination by the distributing agency.

In addition to reporting the information identified above, processors who substitute concentrated skim milk for donated nonfat dry milk must also report the following information for the reporting period:

- The number of pounds of nonfat dry milk used in commercial products sold to outlets which are not recipient agencies; and
- The number of pounds of concentrated skim milk, and the percent of milk solids contained therein, used in end products sold to recipient agencies.

Processor Accountability: The processor must fully account for all donated foods received, used in production, and delivered to the distributing agency and/or the recipient agency. The end products must meet the specifications listed in the processing agreement and the end product data schedule, which is an integral part of the agreement. When end products are sold through a distributor, the processor remains accountable for the donated foods until refunds or any other credits equal to their contracted value have been made to eligible recipient

agencies. Additionally, the processor must maintain accurate and complete records with respect to the receipt, disposal, and inventory of donated foods. There must be documentation in the processor's file to support the data on the performance report.

Additional Requirements for Meat and Poultry Performance Reports: The following information must be contained in the report and be verifiable by the distributing agency.

Inventory of Donated Foods

- The beginning inventory is the same as the ending inventory for the previous month;
- The quantity of donated food shown on the performance report as processed is same as shown on the Agricultural Marketing Service (AMS) grading certificates; and
- Documentation is attached to show the action taken by the processor for condemned donated food.

Inventory of End Products

- The rework data on the performance report agrees with the data on the AMS grading certificates;
- The cases (or pounds) of end product guaranteed was correctly calculated;
- The beginning inventory of end products is same as the ending inventory for the prior month;
- The cases (or pounds) of end products produced is same as the quantity shown on the AMS grading certificates;
- Documentation is attached to show the action taken by the processor for cases (or pounds) short in meeting the guaranteed minimum return; and
- Documentation is attached to show cases (or pounds) of end products delivered.

Calculating Donated Food Usage:

The following methods should be used in calculating the usage of donated foods, which represents the reduction in inventory shown on the performance reports:

- *Substitutable Foods*-Multiply the number of cases sold times the number of pounds contained in a case of the end product as shown on the end product data schedule.
- *Non-substitutable Foods (Meat and Poultry)*- Report the number of pounds of donated meat and poultry processed as shown on the AMS grading certificate.
- *Non-substitutable Foods (Other Than Meat and Poultry)*-The reduction in inventory is to be the quantity of donated food put into production by the processor. The performance report can reflect a reduction in inventory when the following occurs:
 - *Refund method*-after the processor has made disbursement to eligible recipient agencies to cover the value of the donated food(s) in end products purchased;
 - *Discount method/indirect sales*-after the processor has received proof of sales to eligible recipient agencies; and
 - *Transfers from one State to another*-after the processor has received concurrence by the FNS Regional Office(s).

Donated foods received through direct shipments to the processor and by backhauling from recipient agencies should be shown on the performance reports.

If the processor picks up donated foods at the school district level, the processor must maintain a separate inventory for each school district. The processor must also maintain a separate accounting for each school district for donated foods that were allocated prior to the receipt of a direct shipment.

Correction of Errors: If there are errors on previous performance reports, corrections may be shown on the performance report for the current month rather than revising previous reports. If a performance report is amended, the revised report should be clearly marked to indicate that it is a revision of a previous report.

Final Monthly Performance Report: At the end of the agreement year, there is a final 90-day reconciliation period in which processors may adjust their sales to accurately reflect the sales for any month. This is the June performance report with year-to-date totals.

Under no circumstances will the processor be permitted to report any sales that occurred prior to the effective date or subsequent to the expiration date of the approved agreement.

As a part of the annual reconciliation, a processor who has entered into an agreement for the next agreement year may be required to pay the distributing agency the contract value of any donated food inventory in his possession which is in excess of a 6-month supply (if the processor has **not** been specifically approved to maintain a higher inventory level). Additionally, a processor whose agreement has been terminated must return, transfer, or pay, at the discretion of the distributing agency, for any donated food remaining in inventory as required by the State Processing Program regulations.

Prior to forwarding the final monthly performance report to the FNS Regional Office, distributing agencies must certify the accuracy of the report.

On-Site Reviews:

Every year each distributing agency must conduct on-site reviews of 50 percent of the processors whose total operations are conducted solely within that State. This means that a review of all “In-State” processors must be completed by the distributing agency every two years.

Note: This two-year review requirement does not apply to on-site reviews of multi-State processors. Federal reviews do not supplant State monitoring responsibilities. State DA’s have the right to conduct their own reviews of processors whose facilities reside in another State.

Food Losses and Claims:

Under the State Processing Program, processing agreements are entered between the distributing agency and the processor; FNS is not a party to the contract. Because of this contractual arrangement, the distributing agency is responsible for resolving any food losses which may occur at a processor’s plant. Processors must report all instances of out-of-condition donated food to the distributing agency as soon as possible before the processor may take any action. The distributing agency, in turn, must act upon all instances of contamination, deterioration, spoilage, infestation, or latent defects involving donated food. However, if the food loss occurred because of unusual circumstances or if the amount of food found to be out-of-condition is substantial, the distributing agency must contact the appropriate FNS Regional Office to obtain specific technical assistance in handling the loss. See **Procedures For Reporting Out of Condition Food at Receipt** in the Food Ordering section.

FOOD LOSSES IDENTIFIED UPON RECEIPT BY PROCESSORS:

If the processor receives out-of-condition donated food which has been backhauled from recipient agencies, the distributing agency must determine the recipient agency responsible for the loss and follow the procedures in FNS

Instruction 710-1, Commodities Found Out-of-Condition After Receipt by Distributing Agencies.

Claims: Whenever there is a loss of a donated food, a claim determination must be made following the procedures outlined in FNS Instruction 410-1, Rev. 1, Non-Audit Claims-Food Distribution Program.

CLAIM ACTION AND DETERMINATION:

- The distributing agency is required to begin claim action immediately upon receipt of information concerning a donated food loss, and make a claim determination within 30 days of receipt of information of the loss. Exception: No claim determination is required where the value of the lost food is \$250 or less, other than transit claims. The value used to calculate the claim amount is USDA's purchase price of the commodity at the time the loss occurred according to the latest figures supplied from the Commodity File.
- Upon determination that a claim exists and the value of the donated food loss does not exceed \$2,500, the distributing agency must aggressively pursue collection activity. The general policy is to collect claims in full through administrative action. However, claims which indicate fraud, the presentation of a false claim, or misrepresentation on the part of any party having an interest in the claim, must be reported immediately to the appropriate FNS Regional Office. Three written demands must be made at 30-day intervals **or less**, in terms which will inform the debtor of the consequences of failure to cooperate. Action must be taken immediately so that the claim can be paid by drawing down on the processor's bond, letter of credit, or escrow account, if necessary. If the distributing agency fails to pursue a claim within 60 days from the date the claim was determined to exist, FNS has the authority to assess a claim against the distributing agency in favor of USDA.
- Upon determination that a claim exists and the value of the lost foods exceeds \$2,500, the distributing agency must immediately transmit the claim determination to the appropriate FNS Regional Office, fully documented as to the facts and findings. The following information should be submitted to the FNS Regional Office:
 - Description and quantity of the lost commodity;
 - Time and place of the loss;
 - Name of persons having possession at the time of the loss;
 - Circumstances of the loss and the apparent cause;
 - Available evidence and documentation relating to the loss;
 - Date of discovery of the loss;

- Current inventory on hand of the items found to be out-of-condition;
- Description of the condition of the commodity;
- General storage conditions where the commodity was being stored, e.g., temperature, pallet, sanitation, type of storage;
- Schedules, including dates, of extermination treatment, if applicable;
- Precautions against theft or fire, with a copy of the local fire or police department's report, if applicable;
- A finding as to the presence or absence of fraud, negligence, or willful act, and a statement of the basis for such finding;
- A certificate of inspection by health officials;
- Manner of disposal of the out-of-condition commodity; and
- Mechanisms available to the processor to pay for the loss, e.g., bond, letter of credit, or escrow account insurance.

If the FNS Regional Office determines from its review of the claim determination that a claim does exist, the distributing agency must demand restitution from the entities liable, upon receipt of notice from the FNS Regional Office.

PROCESSING AGREEMENT TERMINATION OR CLOSE OUT:

In the State Processing Program, the agreement year begins on July 1 of the current year and ends on June 30 of the next year. Although processing agreements may begin after July 1, processing agreements **may not** continue past June 30. Processing agreements can be terminated any time during the year for a variety of reasons, including the following:

- The processor may decide to discontinue processing donated foods;
- The processor may be having financial difficulties and the distributing agency determines that agreement termination is appropriate;
- Deficiencies identified in the processor's operations may be serious enough to terminate the contract; or
- The appropriate food may no longer be available, etc.

Regardless of the cause for termination, whether it occurs mid-year or at the end of the agreement year, there are specific steps that must be taken to ensure that the donated food in the processor's possession or the value of the donated food is properly returned to either the distributing agency or recipient agency. When agreements are terminated at the end of the agreement year, the close-out procedures should correspond to the annual reconciliation process.

NEGATIVE INVENTORIES:

Before making a decision as to how negative inventories should be treated, consideration should be given as to why the negative inventory balance occurred. For example, if the processor went into a negative inventory status

because the distributing agency was unable to arrange timely delivery of donated food and this delay would have disrupted deliveries to recipient agencies, the negative inventory balances should be replaced by the distributing agency. Ideally, as part of the processing agreement, the distributing agency and the processor should determine how to handle such situations before they occur. However, if a negative inventory balance occurred after the processor was informed that the donated food would no longer be available, replacement product will not be guaranteed. The State Processing Program regulations clearly state that the processor goes into a negative inventory status at his own risk.

If more than one donated food is involved, the value of each donated food can be computed and the values of the positive amount can be offset against the value of the negative amount according to the category of the donated food, i.e., bonus against bonus, entitlement against entitlement. However, this offsetting is only permitted at agreement termination.

COSTS ASSOCIATED WITH THE RETURN OF DONATED FOODS:

In the event a processor terminates an agreement before the end of the agreement year or if the agreement is terminated due to the processor's negligence or non-compliance with program requirements, the processor will be responsible for paying the transportation costs associated with returning the donated foods to either the distributing agency or the recipient agencies. If the agreement is terminated at the end of the agreement year or not approved for the next year, the distributing agency and the processor must negotiate who will pay the transportation costs.

MEAT INSPECTION AND CERTIFICATION REQUIREMENTS

Meat Inspection:

When donated meat products are processed or when any commercial meat products are incorporated into an end product containing one or more donated foods, all of the processing must be performed in processing plants that are under continuous Federal meat inspection. USDA's Food Safety Inspection Service (FSIS) is the Federal agency that oversees the inspection of meat products. However, if a State has been certified to have an inspection program that is at least equal to the Federal inspection programs, the State may perform the inspection. State inspection is only acceptable for intrastate commerce. Any food that crosses state lines must be federally inspected. Meat inspectors assure that all meat packing plants maintain wholesomeness and sanitation requirements for meat and meat products. FSIS also plays a vital role in the Child Nutrition (CN) Labeling Program. This program involves the review of a processor's recipe or product formulation to determine the contribution a serving

of a commercially prepared product makes toward the meal pattern requirements and a review of the CN Label statement to ensure its accuracy. *End product labeling requirements are discussed in further detail in Section IV, Processing Agreement Approval.*

Meat Certification/Grading:

In the State Processing Program, all USDA donated meat products (beef and pork products) must be certified by USDA's Agricultural Marketing Service (AMS) meat graders to ensure non-substitution and non-diversion at a minimum (Option 1 Grading). Optional certifications should be described in careful detail on the end product data schedule and/or the processing agreement. Meat graders cannot perform these certification services unless the meat or meat products are produced in a federally inspected plant. *AMS graders also perform the same services for poultry products, which are discussed extensively in Section VIII., of this handbook, Poultry Processing.*

The United States has had mandatory meat inspection for products prepared for commerce since 1906. There is no charge for these inspection services. However, processors are responsible for paying the costs associated with securing an AMS grader to perform the certification of meat products. The cost of this service is usually comprised of travel, lodging, and an hourly rate multiplied by the number of hours spent overseeing the certification of product. However, in the event the processor can demonstrate that grading is impractical, the distributing agency may approve an exemption to AMS product certification prior to processing an order. Exemptions will be authorized on the basis of each order to be processed, provided the processor can demonstrate:

- That even with ample notification time, the processor cannot secure the services of a grader;
- That the cost for a grader would be unduly excessive relative to the value of foods being processed and that production runs cannot be combined or scheduled to enable prorating of the costs of services among the purchases of end products; or
- The documented urgency of the recipient agency's need for the end product precludes the use of graders.

Prior to approving a processor's request to waive the acceptance service grading requirement, the distributing agency must ensure, based on the processor's past performance, that the quality of the end product produced will in no way be adversely affected as a result of waiving the product certification requirement.

Certification Options:

The end product data schedule is used by distributing agencies, recipient agencies, and processors to specify the end products to be produced and the certification option (Option 1 or Option 2) under which the donated meat is to be processed. Prior to any certification, the processor must provide the grader with a copy of the applicable processing agreement and a copy of the end product data schedule for each end product being produced. These documents will indicate whether Option 1 or Option 2 is required by the distributing agency. Below are descriptions of Options 1 and 2 for donated beef and pork products.

Option 1

This option provides a certification to the distributing agency that the end products have been prepared from the specified donated commodity. Under this option, graders must supervise the processing activity to maintain proper accountability and integrity of donated foods during the processing procedures. This does not preclude the addition of commercial meat or other ingredients listed on the end product data schedule. Processors must provide the graders with detailed information concerning the type and quantity of donated product(s) to be produced. Graders will periodically check product and rework for condition prior to and during processing to ensure product has been properly stored and handled. Any product showing signs of mishandling or improper storage will be retained for FSIS inspectors to make an official determination (rework is the raw or cooked product that has been collected at the end of a production day and may be reused in subsequent productions).

Option 2

This option combines the certification requirements of Option 1 with additional optional certifications requested by the distributing agency in the processing agreement or on the end product data schedule. Although the following requirements are available for optional certification, each requirement is not necessarily applicable to every product. Distributing agencies and/or recipient agencies should determine the level of quality assurance they believe is necessary prior to designating optional certification requirements. This is not an all inclusive list:

- *Condition Examination* -When the addition of commercial meat is permitted on the end product data schedule, the non-donated meat must be examined for excellent condition.
- *Portion Size*-The desired portion size, applicable tolerances, and sampling criteria must be specified. The tolerances and sampling criteria must be reviewed for appropriateness by AMS prior to certification.

- *Amount of Breeding*-The limitations, tolerances, and sampling criteria must be specified. The tolerance and sampling criteria must be reviewed for appropriateness by the grader prior to certification.
- *Formulation*-When specified in the processing agreement, product will be certified in accordance with the formula on the end product data schedule.
- *Net Weight*-Prior to product freezing, 10 shipping units per production lot must be randomly selected and weighed to determine the net weight of product in the sample. Net weight is determined by subtracting a tare weight from the gross weight (the tare weight is determined by weighing empty shipping containers and packaging materials of the same kind and in the same numbers applicable to the 10 shipping units weighed). The total net weight of the sample must be equal to or greater than the total of the marked net weights in the sample. If the total net weight of the sample is less than the marked net weights in the sample, the lot must be rejected. However, lots that are rejected may be reworked and submitted one time only. When examining resubmitted lots, four packed containers per lot must be randomly selected and weighed. The finding of any sample unit in the resubmitted lot that is less than the marked net weight will cause the lot to be rejected.
- *Freezing Requirements*-The processing agreement or end product data schedule may specify that the end product must be frozen to a specific internal temperature within 72 hours after placement in the freezer and/or at the time of shipment. Graders must monitor product in storage to ensure compliance with the time and temperature requirement. Records of temperature verification must be maintained by the processor.
- *Special Labeling*-The processing agreement or the end product data schedule must indicate the use of special markings and/or labeling. Examinations must be performed in accordance with the U.S. Standards for Condition of Food Containers.
- *Packing/Packaging*-The examination of shipping and primary containers must be performed on each lot at the time of production. In addition, when certification is required at the time of shipping from a freezer, an examination must be performed for defects occurring during handling and storage. The U.S. Standards for Condition of Food Containers must be applied.
- *Final Certification*-Final certification at the time of shipping must be performed. Temperature (if required) and physical characteristics of the product will be examined.
- *Metal Detection*-The required level of sensitivity and other detailed requirements related to examination for the presence of metal should be specified in the processing agreement. If not specified in the agreement, the

grader will conduct an examination for the presence of metal in accordance with the procedures set forth by AMS.

- *Other*-The processing agreement must specify any additional requirements, including related quality assurance provisions such as certification in accordance with a specification. If designated, the processing agreement or the end product data schedule must list the specification name and date of issue. All specifications utilized must be approved through AMS.

The processor must obtain a written waiver from an authorized representative of the distributing agency for any deviations from the certification requirements that are included in the processing agreement or the end product data schedule. A copy of the waiver must be provided to the grader prior to certification.

Technical Requirements:

Prior to production, the processor's facilities and operations must be evaluated to provide the most efficient utilization of personnel while maintaining proper accountability and integrity of USDA donated meats. Unless otherwise specified in the processing agreement or the end product data schedule, a processor may commingle donated products from different recipients and/or distributing agencies. Unless specific instructions are included in the processing agreement, rework material, such as broken patties, may be held and used in another production run of similar end product.

Occasionally, sealing straps on containers of USDA donated meat products will be unintentionally broken during shipping and handling. In addition, processors may open a limited number of containers for product examinations, such as product condition, to ensure that the distributing agency is providing an acceptable product. In either case, if no apparent tampering of the product is evident, the product contained in the unsealed boxes shall be acceptable for processing purposes.

Total or Partial Quality Control Programs (TQC/PQC): In order to produce end products which bear the Child Nutrition (CN) label, the processor's plant must have either a TQC or PQC program. The plan should be kept on file and be made available, if requested by inspectors, reviewers, or auditors. Quality control is the processor's responsibility.

Handling Rework:

Rework is defined as wholesome, salvageable product generated during a production run that is not acceptable as the approved end product from the end product data schedule. Rework may not be counted in determining whether a processor has met guaranteed minimum yield established on the end product data schedule. Any raw product that does not go through the entire production

process should not be considered rework. Processors should continue to report rework on Part B of the monthly performance report. Rework which cannot be reincorporated into subsequent production runs should be dealt with according to State Processing Policy Number 26. All rework must be reconciled annually by the State. Rework in inventory may be carried forward into the next contracting year with the mutual consent of the DA and the processor.

POULTRY PROCESSING

Introduction

This section has been prepared to provide guidelines to assist distributing agencies and processors in the processing of the various poultry items being provided through the USDA food donation programs. Processing USDA donated poultry items into finished end products enables recipient agencies to receive the products they desire in forms that are convenient to use, and in many instances, improves portion control at the point of meal service. When done properly, the conversion process can be very cost effective and provide added convenience in meal preparation as well as increasing the variety of products available for menu planning. Proper product combinations and careful evaluation of processors' end products are essential to maximize product return and acceptability of the further processed products delivered to the recipient agency.

The definitions below are used within the discussion of donated poultry processing. In those few instances where the terminology can refer to both poultry processing and other donated food processing, these words are defined both here and in the Section II., *Glossary*, at the beginning of this handbook.

Poultry Definitions

Antioxidants: Antioxidants are used in foods to prevent or inhibit oxidative deterioration of flavor and odor of fats and fatty compounds. These include natural occurring additives such as lecithin, Vitamin E, and certain sulfur containing amino acids. However, some of the most effective additives are synthetic compounds such as butylate hydroxyanisole (BHA), butylate hydroxytoulene (BHT), and propyl gallate.

Bulk Pack: Refers to chickens and turkeys that are specifically packed for further processing. Unless specifically required or agreed to by both the supplier and further processor receiving the product, this product will be delivered in a chilled (not frozen) form. Necks and giblets are not included with bulk pack product. Bulk pack turkeys may not be pre-basted.

Buy-Back Parts: Unused poultry parts not incorporated into end products. These remaining parts may be purchased by the processor, who would then credit the value to the distributing agency or recipient agency. Credit may not be

given for primal parts such as breast and thighs or breast or thigh meat. Credit or buy-back arrangements between the distributing agency or recipient agency and the processor must be established prior to any processing, documented as part of the agreement, and made available to the grader.

Byproducts: Products other than the specified end products produced during processing. Typical by-products which result from processing poultry can be chicken broth, inedible bone, fat, skin, and tails. The value of by-products, which are sold or used by the processor, must be credited to the distributing agency or the recipient agency minus any costs associated with the sale (i.e. packaging, transportation, etc.). Credit arrangements for by-products between the distributing agency or the recipient agency and the processor must be established prior to any processing, documented as part of the agreement and made available to the grader. Processors who do not sell or use any resulting by-products are not required to credit distributing agencies or recipient agencies for the value of the by-products. In these instances, a processor arranges for the destruction of the by-product and incurs any costs associated with its destruction.

Note: By-products can also be buy-back parts; see definition above.

Catch Weights/Random Weights; Catch weight refers to the marked weights on products that, by the nature of their manufactured characteristics, are not packed to a standard weight. agencies, when releasing raw products with random weights to processors for further processing, should assure that the processor credits the actual net weights received instead of providing figures based on average net weights.

Consumer Pack: Refers to turkeys that are individually packaged in heat-shrinkable plastic film bags with good oxygen and moisture barrier properties. This product may be basted (injected with a basting solution) at the option of the supplier for commodity purchases for use in school lunch and other domestic food programs. This product is generally purchased without necks and giblets.

Economic Adulteration: Addition of an ingredient(s) to a product in excess of the generally accepted needs of the end product that results in a lowered value of the item being produced.

Fabrication Procedures: The manufacturing procedures used in making further processed poultry products. For example, when grinding or chopping, the fabrication procedures may include type of equipment used, size of grind, speed of chop, or other procedures that would affect the quality of the finished product.

Formulation: The quantitative listing of all ingredients contained in an individual end product.

Grader: A person licensed as a representative of AMS to examine and certify the production of end products containing USDA donated food.

Guaranteed Minimum Return: The minimum weight or number of units of processed product that will be produced and returned for a set amount of donated food provided. This information is obtained from information on the end product data schedule.

Lipid Oxidation: Union of fat with oxygen that generally results in a lowered acceptability of the food product due to deterioration of flavor and odor of the fats and fatty compounds.

Mechanically Separated Meat (Comminuted Meat): In poultry processing this term generally means the product that results from subjecting poultry frames to a mechanical deboning process where the raw product is finely ground and then by a mechanical separating process the meat is separated from the bone residue. The resulting product is generally used for manufacture of hot dog or bologna type products and, in lesser amounts, is sometimes added to other products such as cooked roll type products, nuggets, patties, etc. It should not be confused with another mechanical separation process being utilized by the poultry industry, which yields product that has a somewhat coarser texture. This type of product is generally found to be more acceptable in ground chicken or turkey products or in other cooked products where a firmer texture in the finished product is desired. *Note: Product labeled as ground is generally recognized by the poultry industry and FSIS as being derived from whole bone-in parts with or without skin in natural proportion.*

Organoleptic: A sensory perception or evaluation of the major quality factors of appearance, texture, and flavor as perceived by the senses of sight, smell, touch, sound, and taste of the individuals performing the evaluation.

Packaging: Packaging refers to the container that is used to protect, preserve or maintain the quality of the donated food. This container is sometimes referred to as a “primary container.”

Packing: Packing refers to the container that is used to include one or more primary containers. This container is sometimes referred to as a secondary container.

Permeable Casing: This refers to the primary container used to hold raw poultry products during the cooking and/or smoking process such as some turkey breast products or turkey ham casings. This type of casing allows for the loss of a certain amount of moisture from the product during the cooking and/or smoking of the product. Products cooked in this type of casing should be repackaged in a moisture and vapor proof casing before freezing.

Primal Cuts/Primal Meat: The meat or product derived from the breast and thigh of chickens and turkeys. Products derived from the breast and thigh (intact

meat portions) may not be purchased or credited by the processor under buy-back or credit procedures. Note: *Buy-back or credit can only be given for carcass parts such as drumsticks, wings, tails, skin, necks, comminuted meat and frames, and giblets (when present). Buy-back arrangements between the distributing agency and processor must be established in writing prior to any product processing.*

Rework: Wholesome, salvageable product generated during a production run that is not acceptable as the specified product stated on the end product data schedule. Products such as broken patties or nuggets, or other defects such as missing breading or lumps and ridges in breaded products would be classified as rework product.

Turkey Ham: Product carrying this identification without the use of qualifiers (such as chunked and formed) must be made from whole turkey thighs that have not been subjected to any size reduction procedures.

Wholesomeness: This term means freedom from external evidence of any disease or condition that may render a carcass or product unfit for food development. Areas that should be addressed in the product specifications include the following:

End Product Data Schedule:

The end product data schedule provides a description of the product to be produced, the product formulation, and the end product return of the donated food and the pricing structure of the end products. Because poultry processing is more complex than processing other donated foods, a separate end product data schedule was developed for use with these agreements. USDA strongly recommends that this standard form be used, rather than a distributing agency developing its own end product data schedule. *See the Contract Approval section of this handbook for additional information about end product data schedules.*

End product data schedules and any attachments thereto must be signed by both the distributing agency and the processor. The processor is responsible for providing copies of the completed forms to the grader for use in supervising the production of the end product. In the event that both signatures are not present, the grader may not permit processing to begin until the validity of the end product data schedule has been verified. All sections of the end product data schedule must be completed or a note made on the form which indicates that specific data is not applicable.

Backhauling

Backhauling is the pickup of donated food from a distributing agency or recipient agency by the processor and transporting it to the plant where it will be further processed. Distributing agencies should discourage recipient agencies from backhauling poultry. Instead, the distributing agency should encourage shipping product directly to the processor for several reasons: 1) it eliminates the risk of taking the product in and out of freezer storage several times, thus providing a more controlled environment for the donated food; 2) it results in producing a better product that has a longer shelf life than product that has been backhauled; and 3) it results in significant savings in transportation and storage.

When frozen foods are thawed, which is done when products are backhauled, a certain amount of moisture is lost from the product. This directly lowers the yield of finished products to the recipient agency and can also have a detrimental effect on the organoleptic properties of the end products. Product shrink accrues to the account of the agency on backhauled frozen product. On the other hand, poultry products that are shipped directly to the processor for processing are shipped in the fresh state with any product shrink being absorbed by the shipper. The fresh products can also be processed when received without the added handling costs that are involved in defrosting frozen products. These cost savings are usually passed back to the recipient agency in the way of lowered processing fees.

However, in the event that products are backhauled, the distributing agency or recipient agency warehouse staff must record the total number of cartons released to the processor, the net weight of each carton, and the aggregate weight of all cartons being picked up. On random weight products such as consumer pack turkeys, the warehouse staff must record the actual case weights and not use the USDA target carton weights. In many instances, actual weights may vary by several pounds or more from the target weights. Backhauled products also must be processed under AMS supervision.

SUBSTITUTION ISSUES:

In the State Processing Program, all donated foods offered by USDA to distributing agencies fall into one of the following categories: substitutable or non-substitutable. Substitutable foods are those donated foods which may be substituted, interchanged, or commingled (stored together) in storage and/or in production with a commercial food of the same generic identity and of equal or better quality. The practice of substituting commercial product for donated food

is commonplace in processing. As listed in the current regulations, the following donated foods are classified as substitutable:

butter	peanut granules
cheese	roasted peanuts
corn grits	peanut butter
cornmeal	rolled oats
flour	rolled wheat
macaroni	spaghetti
nonfat dry milk	vegetable oil
rice	shortening

Any donated food not listed above is considered non-substitutable. But, under certain conditions, and with the approval of FNS, it is also possible for a non-substitutable donated food to be classified as substitutable.

Prior to substitution, the processor must obtain the distributing agency's approval to substitute commercial product. The distributing agency must document all conversations with the processor relating to the substitution request, even if the distributing agency does not approve the request. There are three situations, however, under which the processor may substitute commercial food for donated food without advance approval of the distributing agency. These exceptions to the rule are:

- It is necessary to replace donated food with commercial food to meet the 100 percent yield requirement.
- The substitutable donated food and commercial food have been commingled through the use of joint storage tanks and bins. This situation occurs when a processor, due to the nature of his business, does not store certain foods in traditional warehouse storage. Instead, the donated food will be commingled with the processor's commercial product. An example of commingling would be when a bakery receives direct shipments of donated bulk flour. When the donated food arrives at the processing plant, it is blown directly into the large silos that already contain commercial flour. Once the donated flour is placed in these silos with the processor's commercial product, the identity of the donated flour is lost. Non-substitutable food may not be commingled without the approval of the distributing agency.
- The processing agreement permits the use of concentrated skim milk which has been purchased or manufactured by the processor for donated nonfat dry milk. Since the use of this type of substitution is not very common, please refer to Section 250.30 (f)(3) of the State Processing Program regulations for a complete listing of the

requirements that are imposed when concentrated skim milk is substituted for donated nonfat dry milk.

Even though the above three situations allow a processor to substitute commercial product without advanced approval, processors are still obligated to inform the distributing agency of such substitutions. This notification is usually done at the beginning of the agreement year by means of a letter from the processor to the distributing agency, stating that the processor will substitute commercial product for the substitutable donated food under one or all of the three circumstances. Outside of the three aforementioned conditions for substitution, the distributing agency must give permission in writing to those processors who want to substitute commercial food for donated food.

In addition to requesting approval from the distributing agency to substitute commercial food for substitutable donated food, processors must maintain documentation that the commercial product substituted was domestically produced and of equal or better quality than the donated food specification. For example, if donated butter is Grade A, the commercial product which the processor wishes to substitute must be Grade A or better. The same concept holds true for all commodities that are classified as substitutable. Any questions as to the grade of a particular donated food provided by USDA should be directed to the appropriate FNS Regional Office. Substitution of commercial product produced outside of the United States is strictly prohibited.

When substitution occurs, the processor must substitute “like” foods. This means that the commercial food must be the same type of food as the donated food. For example, a processor may substitute commercial all purpose flour for donated all purpose flour; however, it would not be acceptable for a processor to substitute commercial all purpose flour for donated bakers hard wheat flour. In order to avoid this situation, it is important for distributing agencies to order the kind of donated food that will fit the processor’s needs.

As mentioned earlier in this section, it is possible for a non-substitutable donated food to be classified as substitutable under certain circumstances. In order for this to occur, a processor must request approval from FNS. Before approval can be granted, the processor must prove that the commercial product he intends to substitute is of equal or better quality and of domestic origin as compared to the USDA’s specifications for the non-substitutable commodity.

Processors wishing to substitute commercial product for non-substitutable commodity must make their request to FNS in writing and the request must be accompanied by purchase specifications, a laboratory analysis of the product, a guarantee that this is in fact the product they will be substituting during the agreement period, and any other documentation necessary to prove that the commercial product is of equal or better quality and of domestic origin. All requests for substitution should be sent to the following address:

Director
Food Distribution Division
Food and Nutrition Service, USDA
3101 Park Center Drive, Room 502 POC
Alexandria, VA 22302

Approval to substitute commercial product for donated food only applies to the processor who made the request and is valid for all processing contracts. Furthermore, permission to substitute only remains in effect for the duration of the agreement year in which the substitution was granted. If the same processor had an agreement the following year and wished to substitute the same commercial product, that processor would have to obtain approval from FNS.

To persons not familiar with the processing of donated food, the terms “substitution” and “replacement” may appear to have the same meaning. However, in processing, these terms have very different meanings and this difference comes into play primarily with the production of meat and poultry end products. But, as can be seen by the following example, there are some situations in which the processor may **replace** donated meat or poultry with commercial meat or poultry.

During a production run in which donated chicken was being converted into chicken nuggets, a 500-pound container of donated chicken falls onto the floor. This product, which is now considered unwholesome, is condemned by USDA’s Food Safety and Inspection Service (FSIS) inspector. Rather than pay the distributing agency for the loss, the processor may, with the concurrence of the distributing agency, replace the condemned donated chicken with commercial chicken that has been certified by the AMS grader to be of equal or better quality to that of the donated chicken. By doing so, the distributing agency benefits from receiving the chicken nuggets that would not have been produced if replacement was not allowed.

This type of situation is not viewed by FNS as a substitution since the processor is replacing what was given to him and subsequently lost due to negligence. Also, the replacement product has been graded by an independent source (AMS) who guarantees the replacement product quality.

Replacement of non-substitutable donated foods other than meat and poultry is a rare occurrence. Although donated fruits and vegetables can be lost just like in the chicken example given above, there are typically no AMS fruit and vegetable graders on site at processing plants which convert these foods into finished end products. Without an AMS grader present, there would be no one present to certify that the replacement product is of equal or better quality than the lost donated food. Therefore, when fruit and vegetable losses occur, the processor must pay the distributing agency or recipient agency for the food loss.

The 100 percent yield concept assumes no losses are incurred in the preparation and manufacturing of the donated food. Any donated food losses will have to be replaced by the processor. This concept only applies to those donated foods that are classified as substitutable as listed earlier in this section or to those processors who have been granted approval by FNS to substitute commercial product for a particular non-substitutable donated food. Because substitutable donated foods can be commingled with commercial foods in storage and production, it is impossible to distinguish the two. Therefore, under the 100 percent yield concept, the processor agrees to make up for any loss that may occur during production with commercial product.

THE AMS GRADING CERTIFICATE:

The State Processing Program regulations require that all processing of donated meat and poultry take place under the supervision of an AMS grader. After production is concluded, the grader will issue a certificate listing detailed information about the particular production run.

THE MONTHLY PERFORMANCE REPORT:

Each month processors must submit performance reports to distributing agencies which detail the donated food processing activity that occurred during the previous month. This report shows the number of cases of end product delivered to the contracting agency during the month and also the amount of donated food that was received and used during the month. If donated meat or poultry was used in production, a copy of each grading certificate should be attached to the monthly performance report.

GUARANTEED MINIMUM RETURN:

Guaranteed Minimum Return (GMR) is one of the most important concepts in the processing of donated foods and pertains primarily to processing of meat and poultry. Simply stated, it is the minimum amount of finished end product that is to be returned to the distributing or recipient agency based on the amount of raw donated food supplied to the processor. Prior to signing the processing agreement, the distributing agency must determine whether the processor's GMR on a particular end product is set at a reasonable level. This determination is made by comparing information submitted by processors on their end product data schedules.

When processors do not meet their contracted GMR, the contracting agency needs to be compensated. Usually, the easiest way to do this is for the processor to pay the distributing agency or recipient agency the value of the donated food that would have been included in the cases that were not produced. For example, if the processor was short by 10 cases and, according

to the end product data schedule it takes 24 pounds of beef to make a case, the processor would pay for 240 pounds of beef based on the donated food value as determined by the distributing agency and USDA. Another type of compensation would be for the processor to credit the invoice for the value of the commodity needed to make up for the loss. If the latter option is chosen by the contracting agency, the processor should clearly state on the invoice or in a letter the reason for the credit. Another option would be to require the processor to make up any production losses with replacement commercial product, provided the product is identical to that requested. Ideally, prior to the beginning of the agreement year, the processor and the contracting agency should jointly agree which option of compensation is preferred prior to the beginning of the contract. It is important to maintain any documentation which supports the settlement for missed yields.